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C O N F I D E N T I A L SECTION 01 OF 02 MOSCOW 012963

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SUBJECT: RUSSIAN ENERGY: WINTER GAS, BELARUS, AND THE
CAUCASUS

REF: MINSK 1244

Classified By: Ambassador William J. Burns. Reasons 1.4 (b/d).

11. (C) Summary. This year is no exception to the rule that Gazprom's annual gas tariff negotiations with its CIS customers are blunt instruments, and generally go down to the wire. Deals have not yet been cut with Belarus, Azerbaijan, and Georgia. Gazprom did manage to ink one with Ukraine, thus avoiding a repeat of last year's New Year's cutoff. Gazprom has threatened to increase tariffs for each country, but the greatest danger this winter may be a cutoff to Belarus. Continued pursuit of alternatives where they are commercially viable remains a strong and always-smart energy policy for nations dealing with Gazprom, especially while Gazprom feels more heat at home over inadequate supplies and investment. End Summary.

SUPPLY CONCERNS

12. (C) Gazprom, struggling with a now well-documented production problem of its own, is employing stop-gap measures in order to weather this winter's cold. Shawn McCormick (protect), VP for government relations at TNK-BP, told us that Gazprom spread the word to its industrial customers about six months ago that, at temperatures colder than -15 Celsius, the gas company would begin reducing supplies to this segment of the market. As a result of this announcement, these companies began stocking up on fuel oil as an alternative to gas. McCormick said that Gazprom did this to ensure it could meet its deliveries to the lucrative European market and avoid any further tarnishing of their reputation as a reliable supplier.

THE DEMAND SIDE -- BELARUS...

13. (C) Gazprom's negotiations with Belarus hinge on coming to agreement on the value of Beltransgaz (BTG), the Belarusian pipeline operator (ref A). Gazprom indicated that they would charge USD 200/thousand cubic meters (tcm) unless Belarus turned over a 50 percent stake in BTG, the value of which would then be shaved off of the tariff. Most contacts we have canvassed view a cutoff to Belarus as unlikely and, at worst, expect the two sides to agree to disagree and come up with an artful way of allowing themselves more time to reach some sort of agreement on BTG. One variant we have heard

would be for Russia and Belarus to extend the current gas price with the understanding that any subsequently-negotiated increase would be retroactive to the beginning of the year.

14. (C) However, Vladimir Milov, former Russian Deputy Minister of Energy, warned that there is a real risk of a gas cutoff being repeated with Belarus (which had been cut off two years earlier for a brief period). He agreed that such an outcome would have great reputational costs for Putin. However, he added that many senior energy policymakers and Gazprom officials do not put a premium on Russia's international standing and are driven by more parochial interests, in this case taking control of BTG. For domestic political reasons, Milov predicted that Lukashenko will not be able to give in to Russian demands for BTG and, if the gas is cutoff, he will simply take transit volumes destined for Europe and divert them for domestic consumption. Some investment analysts believe the recent ante-upping moves over the valuation of BTG by "independent" assessors is partly negotiation tactics but is also a serious stab at making the math and the politics work out to everyone's relative satisfaction.

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...AZERBAIJAN AND GEORGIA...

15. (C) Gazprom's stance toward its Caucasus neighbors is markedly different than that toward Belarus. Belarus holds some cards -- transit volumes to lucrative markets -- while Azerbaijan and Georgia do not. As a result, most people we have spoken to believe Gazprom will not hesitate to raise prices and, if no agreement is reached, withhold volumes to the latter pair. Milov noted that, if discussions between

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Turkey, Azerbaijan, and Georgia end up ensuring that Georgia gets enough gas to make it through the winter, then Russia's decision is irrelevant. In particular, he said President Aliyev's public comments about sending Azeri oil through BTC was an indication of Russia's waning influence on energy issues in the region. He called Aliyev's handling of the situation "brilliant" in neutering Russia's ability to extend any gas-related pressure on either of the two Caucasus countries.

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COMMENT

16. (C) Russian energy policymakers are increasingly fixated about dealing with the looming production crunch and ensuring that they fulfill Gazprom's contractual obligations to their European customers. We get the sense that Russian policymakers are expending much more mental energy thinking about gas flows to and through Belarus than to the Caucasus, in spite of the still widespread hostility toward Georgia among senior officials. Gazprom is playing a much longer game with Belarus than it is with its southern neighbors, who will rely much less (if at all) on Russia energy when Caspian gas volumes start flowing in earnest next year. Russia still believes it can win the Belarusian game -- and continue dominating the European market -- but it is slowly dawning on them that Azerbaijan and Georgia have a better hand than in the past.
RUSSELL